

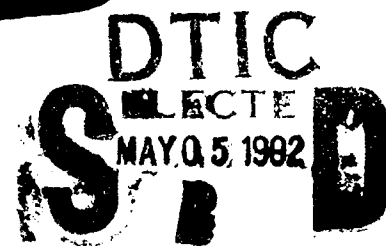
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GERMAN ECONOMIC AND MONETARY UNION

BY

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United States Army

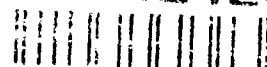
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GERMAN ECONOMIC AND MONETARY UNION

AN INDIVIDUAL STUDY PROJECT

by

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## ABSTRACT

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At midnight on October 2, 1990, the German Democratic Republic (East Germany) was reunited with the Federal Republic of Germany (West Germany) forming a single German state and ending over forty years of political, economic and cultural separation. Political union came with relative ease, occurring less than one year after the coming down of the "wall." Economic union, however, is proving to be much more difficult. The initial euphoria has been replaced by the painful realization that the process of economic integration is going to be very expensive and take a lot longer than originally anticipated. High unemployment, difficulties in privatizing the formerly state-owned enterprises, infrastructure deterioration, environmental pollution and massive immigration are problems associated with reunification which are straining Germany's social, political and economic systems. This paper discusses the impact that these problems and the enormous cost of unification are having on Germany, the European Community, eastern Europe's emerging market economies and the United States.

# TABLE OF CONTENTS

Introduction	1
Political Unification	2
Economic Integration	13
Unemployment	14
Industrial Privatization	18
Agricultural Privatization	25
Environmental Clean-up	28
Infrastructure Restoration	32
Immigration	34
Social Attitudes	38
Impact on the European Community (EC)	41
German Unification and the United States	47
Conclusion	49

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## Introduction

When East and West Germany were united in October 1990, the nation was euphoric. However, by the first anniversary of this historic event, the grim realities of widespread unemployment in the east, enormous financial requirements imposed on the west, and an upsurge in racist activities against immigrants had replaced the celebrations of 1990. The process of absorbing a radically different and largely underdeveloped economy in the east and integrating it with the west is going to take a lot longer and cost a lot more than was originally understood by most. The unification process is subjecting Germany's political, social and economic systems to intense pressure and the outcome is still very much in the balance.

The process impacts more than just Germany. If successful, it could show the way for the ex-socialist economies of eastern Europe and the former Soviet Union as they make the transition to market economies and create a basis for unifying a broader east and west Europe. If unsuccessful, it could undermine the progress made over the last several years in moving towards an economically integrated European Community. The purpose of this paper is to discuss the political, economic and social implications of German unification and its impact on the European Community, the economies of eastern Europe and the former Soviet Union and the world economy as a whole. I will begin with a discussion of the background leading to Germany's political union.

## Political Unification

At midnight on October 2, 1990, the German Democratic Republic (GDR, East Germany) was reunited with the Federal Republic of Germany (FRG, West Germany) forming a single German state and ending over forty years of political, economic and cultural separation. The events of 1989 and 1990 leading to unification caught the world by surprise, occurring with incredible speed, relative ease and lack of violence. This union represented a change of tectonic magnitude and signalled the total breakdown of the entire postwar international order. This change, however, was not just a fortuitous event that popped on the world scene by accident. Rather, it was a product of necessary preconditions developed over a long period of time combined with the timely convergence of a group of world leaders who possessed exceptional qualities of statesmanship and capacity for cooperation.

The preconditions for German unification had their seed in the very first days of the Federal Republic. From the beginning, unification was the goal of West German foreign policy. The preamble to their constitution (called a Basic Law) contained language written by the founders which declared their action to be in behalf of those Germans living under Soviet occupation and stated that "the entire German people is called upon to accomplish, by free self-determination, the unity and freedom of Germany."<sup>1</sup> The fact that the constitution was called a Basic Law rather than a constitution implied that the creation of a Federal Republic

separate from the Soviet occupied east was only a temporary arrangement during which West German leaders committed themselves to bring the two parts of Germany back together again.

In May 1949, the constitution (Basic Law) was adopted and on August 14, 1949, West German voters elected their first parliamentary representatives from which Konrad Adenauer emerged as the first West German chancellor. The three zones occupied by the Western Allies (U.S., French and British) were officially combined as the Federal Republic of Germany (FRG) on September 21, 1949.

The Russians responded to the creation of the Federal Republic by blocking all attempts to unite the Soviet's eastern zone with West Germany. Their intent was to isolate the two zones politically, socially and economically. The Soviets refused to accept any aid from the United States through the Marshall Plan and denied such aid to any of the countries under Soviet domination including Germany's eastern zone. In May, 1949, a communist-prepared constitution was adopted for the east and on October 7, 1949, the Russian zone officially became the Soviet controlled German Democratic Republic (GDR).

Adenauer embarked on a strategy for rebuilding the impoverished Federal Republic which would focus on integration with western ideology and institutions. Although the reunification of both Germany's was a high priority, Adenauer argued for a policy that would first concentrate on rebuilding a German democracy and the restoration of a viable economy. He also recognized the need for protection from Soviet domination as West Germans witnessed the



plight of their countrymen in East Germany. Adenauer pursued political, economic and security (military) integration with the West to include memberships in the European Economic Community and the North Atlantic Treaty Organization (NATO). Although his strong western orientation was perceived as threatening and antagonistic by the Soviets, Adenauer predicted that eventually the "balance of power would shift in favor of the West, and this shift would make possible negotiations 'on the basis of strength' with the Soviet Union. He argued that the Soviets held the key to reunification and would ultimately see themselves compelled to settle the German question on Western terms."<sup>2</sup>

From the vantage point of hindsight in 1992, Adenauer's prediction seems remarkable in vision and foresight, although it is doubtful that he ever thought the process would take over 45 years. In reality, the prospect of a united Germany grew more and more remote as time went on. His strong pro-West policy was extremely successful in terms of political, economic and security achievements. The FRG had a well established democratic system of government, it's "social market" economy had prospered beyond highest expectations and the nation had achieved affordable security through NATO in concert with it's own initiatives to place itself under the American nuclear umbrella and insure continued American military presence. However, in spite of all his successes in resurrecting a totally broken society and seeing it stand the test of time, Adenauer failed in one major area during his political life - German unification. This issue would span

several governments and eventually give all of West Germany's major political parties a chance to participate and affect policy leading to unification.

Throughout the 1950s, opposition to Adenauer's policies came from the Social Democratic Party (SPD). Their top priority was the unification of Germany and although they were not necessarily opposed in principle to reconciliation and integration with the West, they didn't believe that the commitments being made by Adenauer with the West would bring success. In their view, it was creating a European power alignment that would force the Soviet Union to strengthen its grip and presence in East Germany and drive the possibility of unification further away. Their approach favored reducing confrontation and pursuing a policy of compromise and cooperation with the Soviet east as a means to secure unification. The SPD, however, was never able to gain the political power necessary to seriously challenge Adenauer and his Christian Democratic Union (CDU)/Christian Social Union (CSU) coalition government's policies.

Chancellor Adenauer retired in 1963. After more than a decade of Western entrenchment under his leadership, the Federal Republic was firmly planted in the Western Alliance and West German leaders began to look eastward and explore opportunities to improve relations with the Soviet Union and its satellites. Some steps were taken in this direction in the mid-1960s by the Grand Coalition government (a CDU/CSU/SPD alliance) but real change began when Chancellor Willy Brandt and his Social Democrat (SPD)/Free

Democrat(FDP) coalition government were seated in 1966. The new approach was not so much a departure from as it was a complement to Adenauer's policies. Building on their firm integration into the West, West German leaders now set out to conduct a dynamic and innovative policy towards the East. Territorial status quo in Europe, including the division of Germany, was finally recognized by Brandt in the 1970 German-Soviet Treaty. Brandt and his successors Helmut Schmidt and Helmut Kohl each settled outstanding issues and initiated cooperation with the East through bilateral treaties and the multilateral process of the Conference on Security and Cooperation in Europe (CSCE). This move toward more cooperation provided more opportunity for interaction between East and West which effectively transported the "seeds of change and western values into East German and East European societies."

In the end, it was a combination of Adenauer's policy of rebuilding Germany through a total integration with the West complemented later by the "Ostpolitik" of Brandt, Schmidt and Kohl which collectively established the conditions of a stable, democratic government and a strong social market economy required to be in place for the dramatic sequence of events in 1989 and 1990 which led to Germany's unification. Furthermore, each of the major political parties could claim a share of responsibility and credit for their respective contributions to the process, creating for the moment, at least, a sense of political consensus with respect to unification.

Although the existence of favorable conditions were a

prerequisite for successful reunification, they were not the creative forces behind the event. Rather, it was the timely convergence on the world scene of a group of key political leaders who were experienced, unusually skilled diplomats who had previously cooperated and developed personal (sometimes friendly) relationships with each other. Their disposition towards cooperation was absolutely crucial in disposing of a myriad of fears and concerns that arose during the complex diplomatic process involving a multitude of bilateral and multilateral arrangements which ultimately led to unification. A summary of the part played by these leaders follows.

Mikhail Gorbachev was, undoubtedly, the most important personality in opening the doors for reunification. He initiated dramatic changes in Soviet domestic and foreign policy which unleashed forces for greater autonomy throughout the socialist states of central and eastern Europe. In a 1988 United Nations speech, Gorbachev proclaimed "freedom of choice" and renounced the Brezhnev Doctrine. Soviet military power would no longer guarantee the continuation of the communist party's monopoly of power in eastern Europe. He backed his words by announcing the unilateral withdrawal of 50,000 soldiers from Europe and established further credibility by openly accepting the results of Poland's first free elections in 1989 in which Solidarity replaced its communist government.

East Germany posed some difficult problems for the Soviet leader, however. Gorbachev's concept of "perestroika" involved the

idea of controlled reform. Neither control nor reform, however, were in the mind of Erich Honecker, East Germany's hard line communist leader. He remained intransigent and refused to engage in any process of controlled reform despite the change that was happening all around him - confrontation between his government and the citizens was inevitable. The true weakness of the Honecker regime was revealed when Hungary opened its borders for East German refugees to move to the West. By late summer 1989, the East German flow west had escalated into a mass exodus.

Gorbachev's intent was to achieve social, economic and political change through controlled reform; he had no desire to see Germany united and certainly did not want to be party to any initiatives which would result in unification. However, as the situation deteriorated in East Germany and Gorbachev's options became more limited, he became more willing to see conditions develop towards reunification than to support hard line repression and any repetition of a "Tiananmen Square" massacre - a course of action for which East German security forces had made preparations. Gorbachev distanced himself from Honecker and the Soviet leader's subsequent break with the East German regime signalled the GDR's end. Mass public demonstrations forced the withdrawal of the old leadership. In November 1989, the Berlin wall came down. For the first time in forty-five years, the real possibility of German reunification was suddenly thrown into the forefront of world affairs.

West German chancellor Helmut Kohl was quick to recognize

opportunity and take the leadership initiative. The situation was deteriorating in the east and stability needed to be restored. The Honecker government was reeling. East Germans were fleeing to the West in droves and a popular groundswell for unification was growing. By late November 1989, the mass exodus from East to West was well over one hundred thousand people per month and threatened total collapse of East Germany's social and economic system, not to mention the severe social and economic strains it was also imposing on the West. Kohl responded on November 28, 1989, by proposing his 10-Point Plan.

Kohl's 10-Point Plan focused on achieving unity through greater integration of the two separate states. It stressed a "contractual community" of increasing cooperation between the two Germany's which would eventually move towards a confederated union. The plan was intended to project vision and hope into a disintegrating East German society by formulating conditions conducive for the development of democracy and human rights in East Germany. He needed to do something quickly to induce East Germans to stay home. Kohl carefully tied his plan to the multilateral process (European Community, CSCE and East-West disarmament) to reassure both his Western allies and the Soviets. Kohl's approach was gradual and careful. What he failed to recognize was the momentum building in the East for a single, sovereign united Germany now - not sometime in the future. Moreover, this view was not unique to just the East Germans; it was also shared by the United States and recognized by most western leaders. Kohl's 10 -

Point Plan was quickly overcome by the growing forces of unification.

George Bush knew exactly what he wanted with respect to German unity and the ending of the Cold War. During the December 2-3, 1989, U.S.-Soviet summit in Malta (immediately following Kohl's November 28 announcement of his 10-Point Plan), Bush gave forceful support to German unification, placing it in the context of a larger vision of a "Europe whole and free." He also encouraged Kohl to go for unification while the opportunity was wide open and provided the right mix of discreet and public leadership and American resources to address the concerns of its partners.

President Mitterrand (France) and Prime Minister Thatcher (Britain) initially expressed reservations about the prospect of a powerful united Germany - not surprising, given their experience in 1914 and 1939 with such a Germany. In the end, however, Thatcher and Mitterrand both gave their constructive support to unification. A combination of their long post-war tradition of friendship and cooperation and German promises of continued commitment to multilateral institutions such as NATO and the EC provided the necessary reassurances.

German reunification posed some serious problems for Gorbachev which would require great sensitivity and accommodation by western leaders. Of special concern was the military potential of a united Germany in terms of conventional strength, nuclear intent and alliances (NATO?). He was also concerned about the economic impact of losing the GDR as its most important trading partner and a

critical component of Soviet economic recovery. These issues would further intensify the internal opposition which was building against Gorbechev's new policies back home. It was not a good time for Gorbechev to announce more concessions to the West. However, the Soviets held the key to German reunification. If they were going to make the kind of substantial concessions that would be required to meet the western concept of a united Germany, then such concessions would have to be balanced by western accommodation of Soviet concerns and interests.

As Gorbechev, Kohl, Bush, Thatcher, Mitterrand and their subordinate officials continued to work their concerns one by one through a multitude of bilateral and multilateral negotiations and agreements, there remained two major issues to resolve; 1) how to reassure the Soviets in lieu of their very real concerns about potential western exploitation of their withdrawal from central and eastern Europe, and 2) how to resolve the Four Power's rights.

Kohl was the key to addressing Soviet concerns. He met with Gorbechev in the Caucasus in July 1990 and successfully presented a total package that was good enough for Gorbechev to agree to German unity on western terms - terms that meant a single Germany with unrestricted sovereignty, free to choose its own alliances. In return, Kohl offered the Soviets "nine" assurances. These included a transition period through the end of 1994 for the withdrawal of the 380,000 Soviet troops and 220,000 civilians from East Germany; agreement to pay DM13.5 billion for the interim stationing and phased withdrawals of Soviet troops; dignified



conditions attending the Soviet withdrawals; a commitment by Germany to reduce its military forces by 40 percent (370,000 soldier limit) and maintain its non-nuclear status; agreement that only German territorial defense units not under NATO command would be stationed in former GDR territory during the transition period, after which only German forces under NATO command would be deployed with permanent prohibitions against stationing any foreign forces and nuclear weapons in the eastern territories; commitment to nonaggression; and an invitation to the Soviet Union (and east European countries) to address the North Atlantic Council and establish diplomatic links with NATO.<sup>3</sup>

With respect to the Four Power's rights, these were special rights retained by the four victorious powers of World War II - U.S., Britain, France and Russia - in which they held ultimate decision authority on all matters concerning Germany as a whole, its borders and peace settlements. They were derived from the assumption of supreme authority over a defeated Germany in 1945 and had never been terminated. Although these rights gave legal basis for their special role in unification negotiations, it was clear that if German unification was to include unrestricted sovereignty (which it was), then the Four Power's rights would somehow have to be ended. The initial approach sought by the British, French and Soviets was to organize the negotiations as Four Powers negotiating with the two German governments. However, the perception of reviving the old anti-German coalition of fifty years earlier did not bode well with either Germans or the European public.

After intense personal intervention by Bush, a new agreement supported by Kohl and the German government was reached: the two German states together would develop their concept of unification and then communicate it to the Four Powers - hence, the "two plus four" talks. The negotiations proceeded on that basis, avoiding the perception of a "peace conference", and produced the agreements that would be embodied in the Treaty on the Final Settlement which was signed by all six parties on September 12, 1990. On October 1, 1990, the Four Powers declared that they would suspend and cease to apply their rights from the moment of Germany's unification which became effective on October 3, 1990.

The political unification of Germany had occurred in less than one year from the fall of the "wall" and the end of communist control of the GDR. The economic unification, however, is proving to be a much more difficult and much more lengthy process. The next section will discuss the on-going process of economic integration.

### Economic Integration

German reunification brought with it a political and constitutional commitment to raise the living standards of easterners to the west German level as quickly as possible. In the December 1990 election campaigns, Chancellor Kohl (CDU) addressed the cost of unification by promising easterners that conditions would turn around quickly and westerners that they would

not have to pay anymore taxes for it. He was wrong on both counts but won the election. His opponent, Mr. Oskar LaFontaine (SPD) warned of the bitter costs that would be exacted. He was right and lost. This section will look at the problems associated with making the transition from a broken command economy to a viable market economy and integrating it into the west. These problems - unemployment, inflation, privatization, infrastructure repair, environmental clean-up, massive immigration - are not insurmountable but will require a lot of time and enormous investment, both public and private.

#### Unemployment.

Of all the problems associated with German unification, the one foremost on the minds of the east German people is unemployment. According to a September 1991 survey by the ZDF television Politbarometer, unemployment was the single biggest issue in the east, cited by 60 per cent of eastern respondents.<sup>4</sup> In 1992, more than 3 million people, of an already shrunken workforce of 7 million will not have full time work - 1.6 million will be unemployed, the rest on "short time".<sup>5</sup> The reason cited most often for job loss is that wages in the east rose much faster than productivity, hence products which might have been competitive at the former eastern wage levels could no longer compete in the world market and their producers were forced to shut down.

Many argue that maintaining lower wages would have smoothed out the transition. From an economic point of view, that logic is

sound. However, the problem with this view is that it ignores the politics of German unity. Whether right or wrong, the promise of German unification was that east Germans would quickly enjoy west German standards of living. The government moved quickly to this end in July 1991 when it generously decided to exchange East German Marks for West German Duetschemarks (D-Marks) on an even one-to-one basis - notwithstanding that the real value of the East German Mark vis-a-vis the D-Mark would have dictated an exchange rate of seven-to-one or more.<sup>6</sup> This single event effectively increased the cost of labor many fold without any corresponding increase in productivity. The consequence was overpriced east German export products which couldn't compete in the world's markets. This led to plant shutdowns and increased unemployment.

There was more to come which would further undermine eastern competitiveness. West German social attitudes, embodied in their constitutional values, have been institutionalized into an industrial relationship system which provides for centralized bargaining and extensive participation/veto rights for employees. The political terms of unification extended these institutions to east Germany and the result was an immediate round of 20 to 30 per cent pay increases in 1990.<sup>7</sup> These increases in combination with the generous 1:1 monetary conversion rate, drove wages to unrealistic levels. Nonetheless, the government viewed the situation positively and extended its own system of national bargaining in the public service sector to east Germany. The justification was embodied in the familiar argument that the "east

Berlin dustman or bus driver doing exactly the same job as his west Berlin colleague could not go on getting one-third of his salary."<sup>8</sup>

In retrospect, one would have to question the appropriateness of the wage bargaining system given the existing business structure in the east. In reality, there had been no real negotiations. The seventeen German unions clearly had the upper hand "as 'employers' were mainly communist bosses who faced reelection from their employees and were not inclined to play the tough capitalist. The Truehand, owner of the east German companies, took no role in the negotiations. West German employers had no interest in making east German employers more competitive."<sup>9</sup>

Concern about escalating wages didn't surface until early 1991 when two major unions (IG Metall and OTV - the public service sector union) won agreement to equalize eastern hourly wages with the west's by 1994.<sup>10</sup> This event tripped the alarm and prompted the government and employers to blame labor unions for the wave of plant closures and rise in unemployment that was beginning - a target not altogether fair. Not that the labor unions objected to the extension of their power so easily into the east but the government, itself, had played a significant part in the process and, therefore, deserved some share in the blame.

The unions acknowledge the wage-productivity disparity but claim it is not as great as it appears. By the end of 1991, average east German hourly wages had reached a level of about 60 per cent of the west German figure. However, the unions point out that this figure does not reflect working conditions in the east -

longer hours, fewer holidays and the absence of most of the west German fringe benefits. When all factors are considered, the average east German earns about 45 per cent of his west German counterpart - still more than the productivity differences would allow but not as disproportionate as the headline figures suggest, they say. According to some comparative figures cited by IG Metall (Germany's biggest union), metal industry wages in Saxony (east) are 39.9 per cent of the Bavarian (west) level and even in 1994, when "equalization" is achieved, the difference in real compensation will still be 20 percent less due to the non-wage factors.<sup>11</sup>

There is also a position that disregards the productivity issue and argues the benefits of higher wages on their own merits. First, it prevents the migration of the best qualified workers from east to west. Second, it gives eastern business managers a clear view of the long term wage environment for use in making future business decisions. And third, maintaining low wages would actually detract from economic renewal by making the wrong products artificially economic. This view argues that the main problem with east German products is not that they cost too much but rather that they are the "wrong products made on the wrong machines for western markets."<sup>12</sup>

Whether right or wrong, the approach chosen for monetary unification and wage adjustments are too far along to reverse. It would be beneficial if the central bargaining system could be temporarily exchanged for a system based on conditions at

individual plants. Then wage increases justified by the high productivity of new, modern, efficient plants being built (i.e. Volkswagen, Siemens) are not automatically passed on to the old, inefficient factories that will never compete economically without substantial productivity investments and/or subsidies. But that is unlikely given the institutional nature of the system that has been transferred and established in the east. The best option now is to subsidize new investment which is what the government is pursuing in large part through the Treuhand and its privatization function.

#### Industrial Privatization.

The Treuhandanstalt is the government agency responsible for privatizing the formerly state-owned companies of East Germany. It was initially set up in February 1990 by the last communist regime in East Germany in an attempt to begin economic reform towards a capitalistic system. Initially, the Treuhand concentrated on supervising the transformation of state enterprises into joint stock companies. In June 1990, it was given its privatization mandate by East Germany's first democratically elected government. The next few months of operation were characterized by poor leadership, inadequate resources, uncertain direction and incompetent staff workers. However, in August 1990, Mr. Detlev Karsten Rohwedder, former head of the western Hoesch steel company, was appointed president of the Treuhand and initiated sweeping changes that began to turn the agency around. He reorganized into fifteen regional offices, fired useless staff members, many who

were communist holdovers with no concept of a market economy, and started hiring senior West German company executives to fill key positions within the agency. After unification in October 1990, control of the Treuhand passed to the German finance ministry.

Today, the Treuhand is headed by Mrs. Birgit Breuel who succeeded Rohwedder when he was murdered by terrorists in April 1991. A former CDU finance minister in Lower Saxony, she has established herself as tough, knowledgeable and demanding and commands a high level of respect and to some degree, fear, in her current position.

The Treuhand is in effect the world's largest holding company. It currently controls almost 6400 industrial firms<sup>13</sup> not counting the 20,000-plus small businesses (shops, cinemas, restaurants) and over 3,000 industrial firms which it had previously sold through August 1991.<sup>14</sup> It employs a staff of over 3,000 employees - 1,000 of whom were brought in from the west to fill its senior positions. Top management consists of nine managers who run the operation under the scrutiny of a supervisory board drawn from business, trade unions and politics. The Treuhand has also augmented its organic talent with help from the outside; 30 investment banks (mostly foreign) have been retained to help speed sales and advise on techniques like management buy-outs and buy-ins; 90 accountants, lawyers and other business professionals provide independent assessments of a firm's restructuring and privatization plans; and a group of retired west German judges investigate complaints that old-boy networks of top communists are still active within the



Treuhand and its firms - as of September 1991, about 4,000 complaints have resulted in 400 dismissals for political reasons.<sup>15</sup>

The cost of operating the Treuhand and subsidizing its unproductive firms is estimated at DM38 billion for 1991. This includes DM13 billion for restructuring firms, DM6 billion to help workers who loose their jobs and DM7 billion for interest on the DM102 billion debt incurred during the early days of its communist operations. Income to offset these expenses is generated by the sale of firms which are expected to total around DM17 billion in 1991. This leaves a projected DM21 billion deficit for 1991 which is, however, within the limit set by the government's finance ministry.<sup>16</sup>

The task ahead is really threefold: 1) to sell the "good" firms for which there is a market, 2) to restructure those firms which, if given a chance, could become economically competitive, and 3) to shut down those that are hopelessly uneconomical. This is a challenging task of enormous complexity and destined for criticism no matter what level of success is achieved. "Investors complain that it is bureaucratic, economists that it feather-beds firms unfit to survive, trade unions that it is too ready to make quick sales for next to nothing. Tenants and the unemployed call it heartless."<sup>17</sup>

To understand how the Treuhand operates, I will look specifically at each of its tasks, beginning with sales of the previously government owned businesses. Sales of these firms are the Treuhand's only means of generating income but have never come

close to covering its operating expenses. The shortfall is funded by the government's finance ministry. As alluded to above, the Treuhand got off to an extremely shaky start but 1991 sales have been impressive. Through August 1991, over 20,000 small shops and 3,378 industrial firms<sup>18</sup> have been sold and the pace continues at the rate of about 100 firms per week being sold.

However, these sales figures are somewhat illusory. Although they reflect a high count, they are the smaller firms and don't represent the major industrial investments so desperately needed in the east. Of the 400 firms privatized each month, most are small firms or parts of conglomerates. At the end of 1991, approximately one-third of the firms that employ up to 50 people had been privatized compared to less than one-sixth of those firms employing over 500 people.

Another form of measuring privatization performance is in terms of the number of jobs which have been converted to the private sector. Originally, there were 4 million industrial jobs existing in the former state-run industries acquired by the Treuhand. Once western standards of productivity are achieved, those original 4 million jobs would be reduced to approximately 2 million jobs. Therefore, one could establish 2 million jobs as the reasonable target figure representing full industrial privatization. To date, only about 500,000 jobs have been created and most of what remains have very uncertain prospects for the future. The "plumbs" (hotels, newspapers, building material plants, refineries and commercial firms) have been sold and those

firms that remain are further out on the margin in terms of viability and will be more difficult to sell. In the words of Birgit Breuel, Treuhand president, "95 percent of the firms would no longer exist if we (Treuhand) had not provided some financial backing."

Sales are not necessarily based on gaining the highest price. It is a complex package which seeks the best overall arrangement for the firm to include investment pledges and job guarantees. For this reason, the sales "price" may appear on the surface to be quite low. In one case, a plant was sold at Schwarzheide to the chemical giant BASF for nothing except a commitment to invest DM500 million there. In another, Volkswagen purchased the Sachsenring automobile firm, producer of the former East German Trabant, for a mere DM150 million but with associated investment commitments of over DM4 billion.<sup>19</sup>

The complex nature of these kinds of deals has created the perception among many outsiders that the process unfairly favors west German businessmen over foreign interests. Although there is no formal "Germans First" policy, there is no doubt that the common language, historic links with the sought after firms and a basic familiarity with the German legal system provide west Germans a built in advantage over their foreign rivals.

The statistics reflect a relatively small contingent of foreign buyers. Only 156 of the 3378 firms sold through August 1991 were acquired by foreign investors of which nearly half are accounted for by France (47) and Switzerland (22).<sup>20</sup> Treuhand

officials attribute this lack of foreign interest to a failure to recognize the opportunities being offered of getting into the expanding markets of Germany and the European Community. Foreign investors view the high cost of labor, obsolete plant equipment, run down infrastructure, environmental cleanup and high debt as disincentives.

Many of the Treuhand's firms have potential to become profitable enterprises but need major restructuring before they can appeal to prospective investors. The process of restructuring firms is much more complex than selling them on an "as is, where is" basis. Initially, the Treuhand gave its troubled companies guarantees of liquidity, but told them to establish some preliminary balance sheets (in Deutsche Marks) and develop creditable survival plans if they wanted more aid. The response was less than satisfactory. Some complied; others tried to comply but lacked knowledge and ability. They did not understand western accounting procedures and fell far short of putting together any useful comprehensive plan. And, many responded with deceit and corruption. Some examples included former Stasi secret police who "cooked" the books to reflect better than actual performance and thus insure that their conspirator cronies would retain their lucrative management jobs. Other cases were discovered in which bribes were offered from potential west German buyers to "write down" a firm's value in hopes of getting a lower selling price from the Treuhand.

For these reasons of incompetence and/or deception, over 1,400

east German managers have been fired by the Treuhand and replaced as much as possible by west German experience.<sup>21</sup> The Treuhand, however, estimates that up to 20,000 good new managers are badly needed - the lack of which continues to frustrate the Treuhand's restructuring efforts.

Finally, when a firm has no hope of ever achieving profitability and, therefore, no chance of ever selling, the Treuhand will close it down. As of September 1991, a little over 600 firms had been shut down. The impact, of course, is immediate unemployment for the company's workers and, therefore, is done with great reluctance. There are some west German experts who feel there is too much reluctance and favor shutting down all businesses which are simply not competitive in a market economy. Why should the west German tax payer continue to subsidize inefficient, money loosing operations?, they ask, and advocate a policy in which the state should simply put the east German firms up for auction and let the market determine the outcome. The government, however, has not been willing to take the risk, fearing that such a hands-off policy would create unacceptable levels of unemployment and social chaos in the east. Therefore, the Treuhand has adopted its role "as a mix of investment banker, buffer between state and business and general economic nanny"<sup>22</sup> - a role not really out of character with west Germany's "social market" tradition and a role which, at least for the time being, seems necessary to help make German unity work.

Although established as a temporary agency, the Treuhand

appears to have a future of considerable longevity. Despite its impressive sales performance in 1991, it still has more the 10,000 firms to sell - more than when it was originally set up and more than the 6,400 firms currently on its roles. This is due to the need to break apart the unwieldy industrial combines created by the communists into smaller, potentially more attractive units. Furthermore, the rate of sales is destined to fall off as the most attractive firms go first leaving the more marginal firms on the market - many of which may ultimately prove unsalable but will not be shut down for political and social reasons. Today, only 1.8 percent of Treuhand companies operate at a profit. The Treuhand estimates that 30 percent of its remaining enterprises are not viable in the medium term.<sup>23</sup> That may be optimistic, however, as one independent study has concluded that 70 percent of the firms still on the Treuhand's books are not commercially viable.<sup>24</sup> As time goes on, sales will become more difficult, sales revenues will decrease, operating expenses will continue, and annual operating deficits will increase putting more and more pressure on west German tax payers to keep this privatization effort going.

#### Agricultural Privatization.

The state of agriculture in the former GDR is chaotic and deteriorating. Edwin Zimmerman, the agricultural minister in Brandenburg, described the situation as catastrophic.<sup>25</sup> The problem from the perspective of east German farmers is that the prospect of making a viable living as an independent farmer is not

very good. Of the 200,000 farm workers formerly employed in Brandenburg's agricultural sector, only 1,500 have become reestablished as independent farm owners, and that same low level of interest characterizes much of the other eastern leanders.<sup>26</sup>

One of the problems is the high cost of farms and the lack of adequate financing. A typical new farm will cost between DM700,000 and DM1 million but the low-interest loans only go up to a maximum of DM600,000.<sup>27</sup> Without substantial capital of one's own, the chances of becoming independent are as unrealistic as it was under communism.

Meanwhile, in the absence of private interest, the LPGs (agricultural cooperatives) continue to operate but their performance has been dismal. Of the once more than 4,000 LPG operations in eastern Germany, 1,800 are threatened with imminent bankruptcy according to the Farmer's Association.<sup>28</sup> Many are burdened by high debt with high interest rates. The government has offered to forgive old debts if sound reorganization plans are developed and submitted but even so, many of those operations have not bothered to submit the required plans. In the meantime, the burden of debt repayment and high interest rates continue to compound their losses.

One curious phenomenon resulting from unforeseen and unintended opportunities presented by government agricultural policies is the western "flatbed-truck farmers." These opportunist farmers will typically take their own western farmlands out of production, collect the government premium for doing so and use it then to

lease first class agricultural land in the east (premium payments normally will cover a one-year lease). The western farmer then trucks his equipment over for planting and harvesting, leaving it to a caretaker in between. Besides being of no value toward helping easterners make the transition to private independent operations, the transient nature of the self-serving, short sighted flatbed truck operators drive them to ecologically harmful practices more widespread than the former communist LPGs.

Government programs to provide financial assistance to eastern agriculture have been established but accusations of abuse and misuse surround the administration of these programs. "LPG executive board members are accused of having misused government funds provided for taking croplands out of production for other purposes or of having pocketed it themselves. Compensation of the old land owners is being held back. New operations are not getting access to their subsidies. Before the fields are turned over to their former owners, the LPGs are quickly plowing under the ripe winter crops. 'An agricultural system that once produced surpluses is being ruined with a lot of money,' complains a ministerial official from Zimmerman's office."<sup>29</sup>

A lot of money, indeed, is being pumped by the Government into eastern agriculture - approximately DM4.3 billion between mid-1990 and mid-1991.<sup>30</sup> Yet the disintegration of an entire economic sector continues. Of the more than 900,000 current agricultural workers, only about 300,000 will remain. This represents a decline in the labor force greater than any other economic sphere in the



former GDR.<sup>31</sup>

Not only are the people disappearing from the agricultural sector, so is the land. Since reunification, more than 600,000 hectares or about 13 percent of the agricultural area of the east have been taken out of production (at premium EC rates of DM500 to DM750 per hectare).<sup>32</sup> This figure is projected to climb to about a million hectares which will be left fallow and in danger of becoming unproductive prairies.

#### Environmental Clean-up.

Forty years of industrial expansion without any concern for ecological consequences have created severe environmental problems throughout east Germany and all of the former Soviet block eastern countries in Europe. The cost has been high. One-third of the forests are damaged; rivers are polluted by industrial wastes, sewage and oil; and farmlands are contaminated by carcinogenic heavy metal generated by industry. The former East German town of Bitterfeld has gained the infamous reputation as the most polluted town in the world. Throughout the region, rates of pollution-related birth defects and illnesses (leukemia, tuberculosis, respiratory ailments, heart disease) far exceed the national norms.<sup>33</sup>

East German industrial regions are the equivalent of the Ruhr or Pittsburgh regions half a century ago. In the southern provinces, the average monthly deposits of sulfuric compounds exceed 1,000 micrograms per square meter (highest in all of Europe)

with the rest of eastern Germany exceeding 500 micrograms. These levels are directly responsible for the forest damage and forest death which is ongoing.<sup>34</sup>

For comparison, east German sulfur dioxide pollution rates exceed west German levels by three and one-half times - 35 tons of deposits per square kilometer per year versus 10 tons in the west. An analysis of 1988 sulfur dioxide emissions data shows East German emissions were 5,258,000 tons compared to 1,300,000 tons in her western sector.<sup>35</sup>

The structural basis for the environmental conditions suffered today derive from the postwar Stalinist philosophy of generating economic growth by channeling labor, capital and natural resources into heavy industry. Although east Germany was essentially an agricultural region in the highly industrialized prewar Germany, it developed a postwar heavy industrial economy of its own based on indigenous, low quality brown coal.

East German industry developed, as did all of the Soviet's centrally planned economies, with a bias toward heavy and extractive industries and production processes with low efficiency levels in the use of energy and materials.<sup>36</sup> Thus, a concentration on low energy efficient industries required high consumption of energy which was produced by burning low grade coal. This translated into an energy intensity level three times that of the west (measure of energy use per unit of economic output). In simple comparative terms, it takes three times as much energy per unit of economic output as the same sectors in western economies.

This means three times as much coal burned for each kilowatt\* generated or ton of steel produced. And without pollution controls, it means three times the level of air pollution.<sup>37</sup>

Water quality in the east parallels its poor air quality. Decades of deferred investment in wastewater treatment by cities and industry have polluted eastern waters. Most towns and industrial plants discharge their waste water untreated into nearby rivers. Improper solid waste disposal contaminates ground water which threatens public water supplies.

The Elbe River is a sobering example of the tragic state of eastern waters. It has officially been classified a "dead" river and continues to empty enormous amounts of pollutants into the Baltic Sea. Second order effects of excessive pollution are also having an impact on potential economic recovery of the area. Developing the Elbe into a navigable river through a system of locks and dams patterned after western rivers (Rhine, Main, etc.) would create an efficient transportation network for the movement of products throughout the east. However, it has been determined that even if all pollutants entering the river were to cease immediately, it would take years of unrestricted flow before the river could purge itself of existing contaminants. Any system of locks and dams would restrict flow and preclude the river from ever purging itself. Therefore, the eastern economy is deprived of what could have been a significant boost towards economic development.

Despite the enormous task it faces, Germany is committed to cleaning up her environment. She has a reputation of being a

leader in environmental legislation and has imposed upon herself a general target for phasing its rigorous environmental regulations into the east by 1996. With respect to carbon dioxide emissions, Germany has challenged herself with the highly ambitious target of reducing emissions by more than 25 per cent by the year 2005 whereas the EC as a whole is proposing only to maintain current levels by the year 2000.<sup>38</sup>

However, the sometimes conflicting pressures attending reunification seem certain to cause this to slip. The cost of environmental clean-up conflicts with the Treuhand's privatization efforts as outside investment is discouraged by the overwhelming environmental burden. Investors would not only be responsible for modernizing equipment and reducing future emissions but in many cases, they would inherit responsibility for cleaning up residual contamination resulting from the previous 40 years of environmental abuse. A proposed tax of DM10 per ton of emissions for households and industries would incentivize compliance at all levels of the economy but may be politically difficult given the rise in other taxes and the current economic downturn. Nor are the public coffers sufficient to underwrite all of the clean-up costs as reunification costs continue to escalate in many areas.

Furthermore, other pressures associated with market economy dynamics are creating roadblocks in Germany's environmental timetable. The Treuhand sold the right to supply power in the east to a consortium headed by RWE, PreussenElektra and Bayernwerk. They would establish a monopolistic power distribution network

patterned after that in the west. The deal included an investment of DM40-DM60 billion to modernize and clean-up east German electrical production and achieve west German environmental standards by 1996.<sup>39</sup> The sale, however, has been challenged in the Constitutional Court by some 140 east German local authorities who claim the Treuhand deal violates their right to produce and sell their own electricity and thereby denies them a source of badly needed revenues. Whatever the outcome, progress towards creating an environmentally sound energy sector has suddenly ceased and will be substantially delayed pending the court's findings.

The cleaning up of east Germany's water, land and air will require years of effort and large sums of money. It will compete with other equally pressing demands for consumer goods and services as well as the unification requirements discussed throughout this section. The challenge, indeed, will be how to allocate limited resources to accomplish the tasks required yet maintain the public will and political consensus - how to satisfy the needs and desires of the people yet restore the environment.

#### Infrastructure Restoration.

Just as the environment has suffered 40 years of neglect, so has the east German infrastructure; half of the region's 50,000 kilometers of existing roads need extensive repair; 1,300 bridges need to be rebuilt with many of the remaining 6,400 needing extensive repair; and 36,000 kilometers of drains require major work. Railroad lines are in shambles. Sewer and water systems are

collapsing.<sup>40</sup>

The cost of bringing the regions's transportation infrastructure up to western standards is calculated at more than DM200 billion - and this excludes any new extensions. If you add water, drains, environmental works and new roads linking the east to the west, the figure soars to over DM500 billion.<sup>41</sup>

Housing is another sector in critical need. One million homes have been officially condemned as uninhabitable in the east. The Landesbausparkasse estimates that DM600 billion<sup>42</sup> are needed to rebuild the east's housing stock, not to mention the shortage of one million homes in the west - largely a product of economic migration from the east over the last two years.

The bright side of all this is that the building sector has been booming for the last year and could become the engine which pulls the eastern economy out of its slump. Both government and business analysts are projecting economic growth of around 10 percent in the east for 1992 driven mostly by the construction industry.<sup>43</sup>

With boom, however, comes complications. To curb inflation, the Bundesbank has raised interest rates which has caused mortgage rates to increase three percentage points over the last three years. Land prices are also climbing and inflation-plus wage demands are being sought by the construction workforce. IG Bau, the main union, is demanding wage parity with the engineering union plus other privileges such as a 35-hour work week and guaranteed winter weather pay when weather conditions preclude work - demands

which further fuel inflationary pressures throughout Germany.

Investment in the infrastructure is crucial to economic development in the east. Without it, private commercial investment opportunities remain unattractive. With it, investment interest grows and, unlike environmental clean-up, the benefits are readily seen and experienced by a wide sector of the population. But the cost will be enormous and further compound the total bill associated with reunification.

#### Immigration:

Although not directly linked to German unification, the massive influx of immigrants during the last three years is having an impact on the overall process by 1) imposing large financial demands of the government, particularly at the state (lander) level, and 2) aggravating unemployment problems in the east. During the three year period between 1989 and 1991, over 2.5 million immigrants came to Germany seeking new beginnings and a better way life.<sup>44</sup> They fall into three basic categories, each adding its peculiar flavor to the immigration dilemma and each precipitating a different type of social and government response. More than one million were former East Germans, called "Ubersiedlers", who moved to the west between September 1989 and the unification of Germany in October 1990. They, of course, were afforded all the privileges of full citizenship and were a positive influence on the economy by providing a source of labor at a time when there was a shortage of workers.

The second group, called "Aussiedlers", were essentially east Europeans, mainly Poles and Russians, who claimed German descent and immigrated to Germany. Under constitutional law, they are automatically given full German citizenship, eight months of free language tuition, other aids to social and cultural integration and full access to the labor market and social security. Almost one million "Aussiedlers" immigrated during the 1989-1991 period, peaking in 1990 when over 400,000 relocated to Germany. Their number declined to about 220,000 in 1991 but still they represent a significant social and economic impact. Despite the government's liberal investments in language and other integration training, they continue, as a group, to be 25 percent unemployed.<sup>45</sup>

The third group, accounting for 500,000 immigrants over the last three years, are true "foreign" immigrants who are seeking asylum in Germany for political and economic reasons. This group is growing at the fastest rate and now accounts for the greatest number of immigrants crossing the German border. In March 1992, a record 35,000 arrived, mostly from Yugoslavia and Romania.<sup>46</sup> Thus, it follows that it is this group which is causing much of the current social unrest in Germany. A recent German government report revealed that recorded attacks on foreigners increased tenfold between 1990 and 1991, to almost 200 a month.<sup>47</sup> Once again, the old debates have reemerged about multi-culturalism and capacity to absorb more immigrants; about who is really a German and what credentials should be required; and finally, about Germany's liberal asylum laws which attract a disproportionate number of



political and economic refugees.

Germany's liberal immigration laws clearly have encouraged the high level of immigration. In 1991, about 230,000 immigrants entered the country seeking asylum on the basis of political "persecution" in their homeland (largest concentrations from Yugoslavia, Romania and Turkey). In reality, most came for economic reasons which do not qualify as a legitimate reason to stay. The number of refugees who are actually granted official asylum is now only about five percent. However, up to forty percent of all asylum-seekers will be allowed to stay for humanitarian and other reasons such as Yugoslavians fleeing their civil war (26,000 in 1991). Many of those who are officially denied the right to stay are protected from immediate deportation by constitutionally guaranteed right to legally appeal unfavorable administrative decisions which often takes several years to complete. All the while, the government is responsible for providing a basic level of housing and sustenance.

As of this writing, there are slightly less than one million refugees residing in Germany - not counting the two million Ubersiedlers and Aussiedlers or the 5.7 million foreigners who have been granted permanent residency. The current status of these refugees are: 90,000 have been officially recognized as asylum seekers; 500,000 failed to win official recognition but have been allowed to stay for humanitarian or other reasons; and 350,000 are just waiting while their cases make their way through the time-consuming bureaucratic process. The cost of supporting refugees in

1989 was DM4 billion and it is estimated at DM6 billion for 1991<sup>48</sup> - public funds that could otherwise be applied towards the unification effort.

The influx of foreigners at first eased the shortage of skilled workers in West Germany. The IDW, an employer's research body, argues that the influx is benefitting the German economy and only rarely takes jobs away from indigenous Germans. They claim that nearly half of the 1.5 million new jobs created in the last two years were filled by Ubersiedlers and Aussiedlers (jobs that other Germans were unwilling to take) which helped raise the overall level of economic activity. Furthermore, the average age of the immigrant worker is lower than the overall German population, thus the immigrants will help pay the pensions of the dwindling indigenous populations in the next century.

However, there is now great concern that there is no longer any capacity to absorb a continued flow of immigrants without compounding the employment difficulties of many east Germans. The net influx has been running just under one million per year for the last two years. The number of "foreign" immigrants are increasing and although the rate for aussiedlers is declining, there are still an estimated 10 million people living in eastern Europe and the former Soviet Union that can claim German descent and all the privileges of instant German citizenship that go with it should they choose to immigrate. They create a large potential immigrant population that would severely impact the recovery efforts in the east, exacerbating already high unemployment rates and overloading

the social welfare system.

Furthermore, perceptions that the liberal asylum laws are being abused and that Germany is being overrun by indigestible numbers of new workers from abroad has created fertile ground for racist hate mongers and xenophobic reactionaries who are waging a campaign in violence directed at foreign enclaves around the country. This situation is just one more reason for economic aid to flow to the emerging east European democracies and market economies, which will be discussed later in the section on the European Community. If conditions can be improved for "ethnic Germans" in their homelands, then the rate of immigration can be reduced.

#### Social Attitudes:

One of the unique problems associated with German unification is the growing alienation between the east and west German people. Western perceptions of easterners are that they are awkward, lame and lazy. Eastern perceptions of westerners are that they are greedy, arrogant and project a superior attitude. This has led easterners to resent what they see as unfair discrimination and their lot as victims of history. Their resentment is further compounded by what they view as a failure by the average western citizen to understand the full extent of the economic disaster which the former system left behind. In the words of one perceptive east German entrepreneur, "the greatest damage was not inflicted upon roads, houses and the environment, but in people's

heads."<sup>49</sup>

The legacy of mental damage is consistently portrayed in numerous psychological studies. In his book, Pent-Up Emotions - A Psychological Portrait of the GDR, psychotherapist Hans-Joachim Maas describes them as a "nation of repressed, inhibited and chronically dissatisfied victims of dictatorship."<sup>50</sup> Ingrid Stratemann, head of the Dortmund Institute for Industrial Psychology concludes from testing of 4000 eastern job applicants that "when independent performance and decisions are required, they feel rather ill at ease and uncertain .... and all of the sudden they are supposed to set out on a course of economic freedom .... they are not self confident, creative or innovative."<sup>51</sup>

The Industrial Psychology Institute in Eifurt has profiled the east Germans as 5-10 percent "economically active", 60 percent as "biding their time", and 30 percent as "negative and resigned".<sup>52</sup> This is quite similar to Maas' description; 10 percent are "rulers" and "careerists", 60 percent are followers, and 30 percent are "refuseniks" - the emotionally detached, oppositionists and apparently unwordly Utopians.<sup>53</sup>

Although the descriptions and analysis cited above are rather harsh conclusions about the easterner's capabilities today in their new market-economy environment, it does not reflect any inherent character flaw or deficiency. Rather, it is a product of an extremely rapid, radical change which is occurring at a staggering pace. Some psychologists suggest that easterners are handling the transition better than westerners would if faced with the

equivalent degree of change and uncertainty. Michael Baldus, co-owner of the Institute for Personnel and Business Consultation in Cologne, states that fear, unwillingness to learn, paralysis, lethargy, passivity, and outbreaks of violence are not a product of a destroyed psyche but a classic reaction to the all-encompassing uncertainty that is currently disturbing eastern citizens - the very same symptoms that westerners would display in perhaps even greater degree if confronted with the same turbulent, uncertain conditions.

Nearly all psychologists vehemently reject the western prejudice that easterners are lazy. Stratemann states that "you will find outright unwillingness to work much more often in the west." This stems from a value system in which many westerners have come to regard work merely as a job far less important than achieving social status as measured by consumption in their free time. Under socialism, however, hard work was not rewarded by material success. Rather, it promised security and social recognition within a value system in which a Prussian-like devotion to duty strengthened a sense of belonging to a group which is often a greater motivation than the material. The Stratemann studies concluded that "thousands of applicants analyzed have shown that motivational factors enhancing performance, such as frustration tolerance, are usually greater in the east."<sup>4</sup>

Stratemann further noted that easterners have shown a greater ability to empathize with colleagues, bosses and subordinates and are more willing to seek harmony and compromise. "We found a much

greater ability to adapt in a flexible manner to new situations than was the case with westerners."<sup>55</sup> In contrast, the western approach for managers is to act decisively and quickly, set goals, and seek domination rather than compromise within a group. These contrasts are difficult to reconcile and will generate conflict for a long time creating a sense of superiority in the west and a striving for emancipation in the east. Forty years of socialist indoctrination will not be undone quickly. The challenge for economic integration is for westerners to familiarize and understand the old system in the GDR. That will develop greater tolerance of eastern behavior and allow differences to gradually disappear. Nonetheless, the consensus among psychologist is that easterners and westerners as distinct types will be around for a whole generation to come.

#### Impact on the European Community (EC)

The effect of German reunification thus far has been to strengthen the commitment of all members to the EC and to push for accelerating the integration process. Underlying this stepped up interest in European integration was the fundamental question of how to deal with the enormous 'power' a united Germany would represent in the Continent. This was a concern not only to her European partners but also to Germany herself, although European

political leaders were extremely reluctant to express these concerns publicly, preferring to couch them in terms promoting a unified Europe rather than confronting directly the 'power' issue. No European country wanted to thwart Germany's reunification effort but there was uneasiness about her certain dominance that would emerge.

French President Mitterrand and EC Commission President Jacques Delors determined that the best way to dilute German power was to integrate her more tightly into Europe. In April 1990, they extracted a promise from Kohl that Germany would step up integration and accept European monetary union by the end of the decade. This commitment was further solidified in the Masstricht Summit in December 1991, when agreement was reached to adopt a common European monetary system by 1999 at the latest.

Germany, herself, was not comfortable with the prospect of once again becoming the dominating force in Europe. No doubt she was sensitive to the concerns of her partners, particularly France and Britain, given that twice before in this century they had been the object of aggressive German power. But apart from any concerns about world perceptions, there was a genuine reluctance to assume the role of a dominating power and the burdens which come with it. In a Der Spiegel survey in October 1990, only 23 percent of German respondents thought Germany should be a major power in Europe whereas 47 percent were opposed to such a prospect.<sup>56</sup>

From the beginning, German leaders charted a course that would reassure (if not placate) her European neighbors of Germany's

trustworthiness: all suggestions to obtain a permanent seat on the UN Security Council were eschewed; Germany signed a landmark non-aggression treaty with Russia consistent with her NATO obligations; but most important of all, she pushed for greater European unity which would effectively constrain her increased power within the framework of multinational decision making bodies such as the EC's central bank, commission and parliament.

Germany has done well by the EC and the overwhelming consensus is, why change? Her profound commitment to the European vision is embodied in the words of Chancellor Kohl; "Our freedom and our well being are inseparably bound to the European Community and the Atlantic Alliance....Together, with our friends and partners, we want to make our contribution to the building of the United States of Europe."

There are, however, some challenges to EC solidarity beginning to emerge; one, the enormous costs associated with reunification are having an impact on the German economy which is adversely impacting the other EC countries; and two, Germany's geographical position on the line between east and west and the seductive lure of eastern orientation and opportunity is threatening to divert attention and resources away from the thrust of greater EC integration.

The impact of cost reflects the dominating influence of the German economy on the EC. The German economy is the benchmark for all of western Europe. All of the EC currencies are tied to the Deutchesmark and interest rates throughout the Community are



impacted by the Bundesbank actions. Therefore, whatever the German economy does directly impacts other EC economies. Right now, the German economy is feeling the strains of reunification. The costs are proving to be much more than were ever publicly acknowledged and probably much more than ever anticipated in the private cubicles of government analysts. In 1991, DM140 billion were transferred from west to east<sup>57</sup> - a figure which represents 50 percent of the former East German GNP and a figure which equates to DM3,000 for every man, woman and child living in the east. The projection for 1992 is DM180 billion.<sup>58</sup>

The cost of reunification has created a financial dilemma for the government. Having raised taxes to their politically feasible limits, German leadership has had to turn to borrowing. As recently as 1989, Germany enjoyed a balanced budget but the public sector deficit in 1991 climbed to DM140 billion ( 5 percent GNP). This, in turn, is creating new inflationary pressures. Increased deficit spending and high consumer demand (generated by unrealistically high wage levels and the generous 1:1 exchange for East German Marks) have created the highest rates of inflation in nine years. The Bundesbank, charged with insuring a stable Deutschesmark, responded by increasing interest rates.

While this approach may have been the most politically acceptable within the German boundary, it has met with growing discontent among the other EC countries and begs the question of just how strong is Germany's commitment to the EC. EC governments say to Bonn, raise your taxes, not interest rates and blame the

high interest rates set by the Bundesbank for aggravating the economic problems in their respective countries. Faced with economic slowdown and rising unemployment, the western European economies need just the opposite of what the Bundesbank is forcing. They need lower interest rates to fight recession but since their currencies are pegged to the Deutschemark, they are denied the freedom to make the required rate adjustments. Instead, their interest rates are forced up by the Bundesbank's actions which are driven by German policy - policy which, in their view, is a "Germany first" solution at the expense of the rest of the EC countries. If this trend were to continue, popular support of European unity could begin to wane and undermine the integration process as political pressures could force a shift in emphasis back to national policies vis-a-vis integrated EC solutions.

Another threat to continued EC integration is Germany's central geographic location. Once again, Germany sits astride the line dividing east from west in Europe and is subject to very different demands being placed on it by its neighbors from each side. Without any malicious intent or grand design to create a central European hegemony, Germany's location will naturally enhance its new power. Germany is so much stronger, more developed and more cohesive than its neighbors to the east that it is inevitable that the weaker eastern nations will fall into Germany's orbit to some degree.

Initially, the German understanding of "East" meant the former GDR and Soviet Union whose acquiescence was required for the

unification process. With the collapse of the Soviet Union and the COMECON trading block, however, countries like Poland, Hungary and Czechoslovakia are looking to Germany for aid and as a source of investment. These eastern nations are legitimate struggling democracies in desperate need of economic assistance. Their success in making the transition to a democratic, market economy is of critical importance to Germany. Therefore, it is only natural for Germany to begin to look eastward, notwithstanding all her stated intentions to focus on integration with western Europe. Furthermore, since there has been a conspicuous absence of aid to the eastern democracies from other west European countries, Germany feels compelled to extend a helping hand.

Germany's view of the east is different than that of the other Western powers - comparable in a sense to how the U.S. looks at Central America and the Caribbean. The social, economic and political conditions of the central and eastern european countries will directly impact the health of the east German economy throughout its transition period and beyond. If conditions fail to improve, eastern Germany as the first stop in the west, will have to deal with immigrants from the east seeking economic relief. This will further frustrate Germany's own efforts in building economic stability (unemployment, housing). On the other hand, economic development in the east would create new markets and reciprocal trade opportunities in which east European goods are imported rather than their people. Therefore, although German investment initially has primarily focused on the former GDR, there

is a growing sense of urgency and more willingness to explore opportunities beyond its eastern borders.

Germany is going to have to develop an eastern policy which will inevitably include an eastern orientation not shared by the west. When it does, the psychological distance between German and western leaders will likely grow. This could lead to a divergence between west European interests and those of a "Germany that must absorb a radically, different and largely underdeveloped economy that faces east, not west.... This could force new fiscal and even diplomatic priorities that might not always converge with the west."<sup>9</sup> The fundamental strategic options faced by Germany today are to maintain solidarity with a "United Europe" (EC) or to pursue a separate course which may extend toward the east. For the moment, the commitment is clearly toward the "United Europe." But pressure to the contrary may likely build with time as the struggle with unification continues and new leaders emerge who are more removed in time and memory and, therefore, less apprehensive of the historical consequences of a "Mitteleuropa."

#### German Unification and the United States

The relationship between U.S. policy and the reunification of Germany lies in large part to the economic significance of Europe and the EC in particular. The EC is the largest trading partner of the U.S. Two-way trade in 1990 totalled \$190 billion which

included a \$6 billion U.S. trade surplus. As Europe continues to integrate and EC '92 approaches, it is vital to U.S. economic interests that the U.S. have access to European markets. In 1993, the EC will become the world's largest single borderless market with 340 million consumers. When considering the potential of an expanded EC in the future and the emerging market economies of eastern Europe, U.S. access to European markets becomes even more critical.

Germany is the key to protecting U.S. interests in a changing Europe. Its Gross Domestic Product in 1991 accounted for 31 percent of the EC's as a whole and its position of dominance will continue to grow as German monetary union matures. Dominance means influence and on this basis, President Bush pursued a policy of aggressive support for German reunification from the very beginning. Since the union was inevitable once the wall came down, why risk the chance of strained relations with anything less than full support of reunification? American policy was, therefore, based on the assumption that it was in the best interest of the U.S. to support a unification process that would produce western Europe's most powerful nation and a potential partner in the creation of a new European order.

However, the mounting costs of unification and its impact on economic recession throughout Europe is also creating concern for the United States. Recession in Europe means less opportunity to export U.S. goods and services and reduced export markets means slow economic recovery and prolonged recession in the U.S.

Furthermore, the European recession is creating a tendency for individual countries to turn inward and adopt self-serving nationalistic policies which threatens not only further European economic integration but even worse, protectionist policies. From the U.S. perspective, a stable Europe with integrated markets accessible to the U.S. is a primary goal. Germany holds the key. If reunification can be accomplished successfully without adopting policies which destabilize the rest of Europe, then the U.S. interests will be well served.

### Conclusion

This paper has keyed on a multitude of economic issues associated with Germany's reunification. Political union came with relative ease. Economic union is putting great strain on Germany's political, social and economic systems. The cost of unification is enormous as Germany attempts to transform an obsolete and broken economy into a viable market economy fully integrated with its western counterpart. Privatization, industrial modernization, environmental clean-up, infrastructure repair, financial support of Soviet military forces and enormous social welfare transfer payments to the east are requiring great amounts of public financing. Interest rates have been driven to their highest levels in nine years as a result of accelerated deficit spending and high consumer demand in the east (generated by unrealistically high wage levels and a generous 1:1 exchange ratio between east and west

German marks). All this is straining the German economy and causing her to look inward at a time when the EC desperately needs a strong German economy to lead the EC toward unity and economic growth.

Will Germany be able to overcome these difficulties associated with reunification? This writer believes the answer is clearly yes. It may take longer than first anticipated and it will certainly cost a lot more, but Germany's overall economic strength will be more than adequate. The process may strain social relationships and attitudes between east and west - westerners complaining about the financial burden they are being forced to carry and easterners feeling they are being exploited by westerners buying up only the best business opportunities without a sincere effort to invest in jobs and industry in the east. However, in time, these differences will fade and a fully unified Germany will emerge with a competitive economy in the east, fully integrated with the west, creating enormous economic power in the region.

Will Germany continue to lead the EC on its path towards greater integration and full economic and monetary union by 1999 as agreed to at Maastricht last December? The answer here is less certain. Although German unification originally strengthened the Communities commitment to greater and faster economic and political integration (to alleviate any concerns about an emerging "Fourth Reich"), the high cost of unification is taking its toll here also. A shift from a "Community" perspective to an inward looking nationalistic viewpoint is beginning to emerge. The key factor

will be whether the Bonn government can successfully integrate the two parts of Germany. If the enormous transfers from west to east continue, and are financed by public sector deficits and high interest rates, the impact on the EC will be destabilizing and divisive. High German interest rates will prolong economic problems throughout the whole of western Europe and undermine its progress towards economic and monetary union. Truly, German unity and European unity are inseparably tied. They are, as chancellor Kohl has often referred to them, as "two sides of the same coin",<sup>60</sup> both of which are beginning to show some signs of tarnish.



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